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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

FRANKLIN FEDERAL SAVINGS BANK, et al.,
Petitioners,

vs.

DIRECTOR, OFFICE OF THRIFT SUPERVISION, et al.,
Respondents.

On Petition for a Writ of Certiorari to the
United States Court of Appeals
for the Sixth Circuit

BRIEF OF SECURITY SAVINGS AND LOAN ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER FRANKLIN FEDERAL SAVINGS BANK

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QUESTION PRESENTED

Whether the Financial Institutions, Reform, Recovery and Enforcement Act of 1989 ("FIRREA") permits the Office of Thrift Supervision ("OTS") to abrogate binding contracts entered into between savings and loan associations and Federal Home Loan Bank Board ("FHLBB") and/or Federal Savings and Loan Insurance Corporation ("FSLIC").

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BRIEF OF
SECURITY SAVINGS AND LOAN ASSOCIATION
AS AMICUS CURIAE IN SUPPORT OF PETITIONER
FRANKLIN FEDERAL SAVINGS BANK

INTEREST OF AMICUS CURIAE

Security Savings and Loan Association ("Security Savings") respectfully submits this brief as *amicus curiae* in support of Franklin Federal Savings Bank's Petition for a Writ of Certiorari. Security Savings has obtained letters of consent to file this amicus curiae brief from the parties, which it files contemporaneously herewith in accordance with the Rules of the United States Supreme Court, Rule 37.2. 28 U.S.C. (1990).

Security Savings is a stock, state chartered savings and loan association organized under the laws of the State of Mississippi. It was chartered in 1961 and is presently

headquartered in Jackson, Mississippi. Security Savings is not now and never has been an institution engaged in fraud or corruption, has no history of excessive officer and director salaries and has never paid dividends to its shareholders. It has reinvested its earnings back into its operations and has sought to serve the financial needs of its community for thirty years.

On September 26, 1990 Security Savings filed suit in the United States District Court for the Southern District of Mississippi against the Director, Office of Thrift Supervision ("OTS") and other federal agencies to enjoin the enforcement of certain regulations of the OTS, which contravened the terms of a binding agreement Security Savings had with OTS's predecessor agency, Federal Home Loan Bank Board ("FHLBB"), and which were contrary to certain provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), Pub. L. No. 101-73, 103 Stat. 183 (codified in 12 U.S.C.). On February 26, 1991, after a full evidentiary hearing, the district court entered a permanent injunction enjoining the government from reneging on its agreement, holding that FIRREA preserved the rights and obligations of the parties arising from that agreement. Security Sav. & Loan Ass'n v. Director, Office of Thrift Supervision, 761 F. Supp. 1277 (S.D. Miss.), *appeal docketed*, No. 91-1570 (5th Cir. May 24, 1991). That judgment is currently on appeal in the United States Court of Appeals for the Fifth Circuit. It is one of the four appeals referenced by Petitioner and one of the thirty-four pending cases identified by the government, each of which raises similar issues.

The resolution of each of these cases turns upon the proper construction of certain provisions of FIRREA. The district courts, the Courts of Appeal, the savings and loan institutions affected by these particular provisions and the federal agencies are in critical need of uniformity and

guidance from the United States Supreme Court. It is of paramount importance to Security Savings and each of these institutions that this question of statutory construction be resolved as promptly as possible.

ARGUMENT

I. BACKGROUND OF THE ISSUE

Over the last decade, the thrift industry has experienced tremendous change and turbulence, both in the laws and the regulations governing it and in the resulting financial impact upon the industry. To fully understand the issue presented by the Petition, it is necessary to understand the historical and economic forces that ultimately led to the "savings and loan crisis" and the efforts by FHLBB and FSLIC in the mid-1980's to adopt procedures to deal with the then rapidly growing number of insolvent institutions. The unifying issue presented by the numerous cases now pending throughout the country can only be understood in the framework of these events.

FSLIC is an agency of the United States, which, under the National Housing Act of 1934, as amended, was charged with, among other things, insuring the accounts of depositors in savings banks and savings and loan associations that were members of the Federal Home Loan Bank system, and enforcing compliance by such institutions with regulatory capital requirements. Prior to 1989 and the enactment of FIRREA, FSLIC was operated under the direction of FHLBB, pursuant to Title 12 United States Code Section 1725 (1987).

Under the Home Owners' Loan Act of 1933, as amended, FHLBB was charged with, among other things, regulating and supervising federally chartered savings and loan associations, acting as the operating head of FSLIC and enforcing compliance by such institutions with regulatory capital requirements established under Title 12 United States Code Section 1464(s)(1989).

During the late 1970's and early 1980's, unprecedently high interest rates pushed the cost to thrift institutions of obtaining and retaining new deposits substantially above the rate of return on long term-fixed rate mortgages and thrift portfolios. As a result of the substantial "negative spread" between the thrift industry's cost of funds and its return on assets, the industry sustained heavy operating losses in 1981 and 1982.1/

The magnitude of the losses was immense. In 1981-1982, the thrift industry sustained an operating loss of $8.9 billion, with a record of $3.3 billion in the first half of 1982 alone. During the last half of 1981 and the first half of 1982, more than 80% of all FSLIC-insured thrifts incurred operating losses. 1985 FHLBB Ann. Rep. 5-6.

In the mid-1980's, the number of troubled thrifts increased, as did losses to the FSLIC fund. As a result of the deteriorating condition of the FSLIC insurance fund, FHLBB sought to find healthy thrifts or other investor

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1/ Housing And Urban Renewal Recovery Act of 1982: Before the Subcomm. on Housing and Community Development of the House Committee on Banking, Finance and Urban Affairs, 97th Cong., 2d Sess. (1982) (testimony of Richard T. Pratt, then Chairman, FHLBB).

groups to acquire or recapitalize troubled institutions through the use of FSLIC's authority, under Section 406 of the National Housing Act. 12 U.S.C. § 1729 (1987). Many of these "supervisory transactions" were "assisted transactions" in that they involved some new infusion of capital by FSLIC and/or the granting of regulatory forbearances by FHLBB and/or FSLIC which permitted the institutions to continue to operate, but with modified capital requirements. Under Section 406, FSLIC was authorized to provide financial assistance to acquiring institutions.

Although the cost of arranging these mergers was high, doing so preserved funds which otherwise would have been expended in a liquidation of the failing thrifts. As an example, in 1981 FSLIC provided financial assistance to thirty supervisory mergers in the form of cash contributions, FSLIC notes, and asset purchases. The total cost (calculated using the present value method) of the first seven of these was $344 million. Nevertheless, FSLIC's cost was only seventy-five percent of the cost that FSLIC would have incurred had it been forced to liquidate the seven troubled thrifts and pay off the depositors. 1981 FHLBB Ann. Rep. 16.

By year-end 1981, the FSLIC fund was down to $7 billion. As more and more FSLIC-insured thrifts became insolvent or troubled, FSLIC and FHLBB realized that continuing to facilitate supervisory mergers with cash contributions and FSLIC notes would exhaust the

insurance fund by April, 1982.[2/] The number of problem cases, the volume of assets handled by FSLIC and default prevention transactions continued on record levels in 1983. During 1984 and 1985, the continued growth and the size and complexity of problem cases requiring FSLIC intervention created a record-high demand on FSLIC resources, precipitating a further decline in FSLIC reserves from $6.4 billion at the end of 1983 to approximately $5.6 billion at the end of 1984. 1985 FHLBB Ann. Rep. 25, 29.

FSLIC resolved thirty-five problem cases in 1985 involving total assets of $6.5 billion. 1985 FHLBB Ann. Rep. 26. Twenty-five of these cases involved asset assisted acquisitions representing $4.4 billion in total assets. Yet due to the willingness of the private sector to participate in assisted transactions, the cost to FSLIC was reduced. Through techniques such as interstate, inter-industry, and private-investor acquisitions, the twenty-five assisted acquisitions saved FSLIC $547 million over the estimated cost of liquidation. Id. at 25.

FSLIC's capital needs became desperate in 1986. The total reserves for FSLIC had diminished by year-end to negative $6.3 billion. 1986 FHLBB Ann. Rep. 15, 25. In 1986, the gap between profitable thrifts and unprofitable ones widened, with approximately one-fifth of the institutions experiencing accelerating losses. Id. at 2, 5. FHLBB and FSLIC resolved twenty-seven problem thrifts with assisted mergers and acquisitions in 1986, involving $7.4 billion in assets, and FSLIC still was forced to liquidate ten institutions in 1986. Id. at 27.

2/ Report by H. Brent Beasley, Director, FSLIC, Annual Stockholders Meeting of the Federal Home Loan Bank of Topeka (Apr. 13, 1982).

In sum, it was apparent that FSLIC lacked the financial resources to honor all of its obligations to depositors of the troubled thrifts. To help alleviate the pressure on these funds, FSLIC and FHLBB carried out a policy of negotiating, on a case-by-case basis, beneficial regulatory capital terms and conditions to encourage healthy thrifts to merge with the failing thrifts, thus taking these failing thrifts off the government's hands at the smallest out-of-pocket cost.

A. FHLBB POLICY REGARDING "SUPERVISORY GOODWILL"

Among the terms agreed to by the agencies was the ability to report "supervisory goodwill" as an asset for purposes of calculating regulatory capital. In mid-1981, when the FSLIC insurance fund was first severely threatened, FSLIC and FHLBB were forced to revise their assistance policies regarding supervisory mergers in order to prevent, or at least forestall, exhaustion of the fund. Among other changes, FSLIC and FHLBB began to induce healthy institutions to acquire failing thrifts at a substantially reduced cost to FSLIC by adopting an aggressive application of the "purchase method" of accounting for mergers.

Then applicable Generally Accepted Accounting Principles ("GAAP") required, in acquisitions using the "purchase method" of accounting, that the book value of the acquired thrift's assets and liabilities be adjusted ("mark-to-market") to fair market value at the time of the acquisition. Any excess in the cost of the acquisition (including liabilities assumed by the acquirer) over the fair market value of the acquired assets was separately recorded on the acquirer's books as "goodwill" -- an intangible asset to be amortized under GAAP on a straightline basis over a period of up to forty years.

The history of the FHLBB approach to goodwill was described in the statement of Richard T. Pratt, Chairman of FHLBB from 1981 to 1983, before the United States House of Representatives, Committee on Banking, Finance and Urban Affairs, October 1, 1990 (hereinafter "1990 Pratt Statement").

> As a general matter, the inclusion of goodwill was permitted under GAAP and, at that time, it allowed goodwill to be amortized over its estimated life, not to exceed 40 years. The Bank Board permitted goodwill for capital purposes in accordance with GAAP. To varying degrees, other federal banking regulators (the Comptroller, FDIC and Federal Reserve Board) similarly permitted the inclusion of goodwill and/or core deposit intangibles in the capital accounts of commercial banks or bank holding companies during this period.
>
> The Bank Board was caught between a rock and a hard place. While it did not have sufficient resources to close all insolvent institutions, at the same time, it had to consolidate the industry, move weaker institutions into stronger hands, and do everything possible to minimize losses during the transition period. Goodwill was an indispensable tool in performing this task. The GAAP approach to purchase accounting mergers provided a bridge which allowed the Bank Board to encourage the necessary consolidation of the industry, while at the same time husbanding the financial resources which were then available to it. It facilitated mergers without incurring the inordinate cash costs

> associated with liquidating institutions during the most unfavorable cyclical peak in American economic history.

Id. at 80, 81 (footnotes omitted).

Thus, in an acquisition in which the aggregate fair market value of liability assumed by the acquirer exceeded the aggregate fair market value of the failing thrift's assets, the excess was carried on the resulting institution's books as goodwill. FSLIC and FHLBB gave continued assurances to the acquiring institutions that this "supervisory goodwill" would be includable as capital for purposes of satisfying regulatory minimum capital requirements, and that it could be amortized over periods of up to forty years. In giving this encouragement, FHLBB intended to, and did, induce healthy institutions to acquire insolvent or failing thrifts with reduced cash assistance from FSLIC, thus preserving its fund.

In 1982, the Financial Accounting Standards Board issued a Statement of Financial Accounting Standards No. 72 ("FASB 72") amending GAAP applicable to mergers initiated after September 30, 1982. FASB 72 generally required that goodwill arising under the purchase method be amortized over a period substantially shorter than previously allowed. However, so valuable was the supervisory goodwill to the disposition of insolvent thrifts that FHLBB and FSLIC continued to induce healthy institutions to acquire failing thrifts by allowing supervisory goodwill to be included in regulatory capital to be amortized over a period of time exceeding that then allowed by GAAP.

Indeed, supervisory mergers using purchase method accounting became a "supervisory tool," designed, as then Chairman Pratt acknowledged, to "spread as much of the industry's own net worth as possible over the industry's

troubled spots as a means of conserving the FSLIC's insurance fund."3/

FHLBB's assurances to acquiring institutions that they could utilize purchase accounting and the resulting goodwill was critical to inducing healthy institutions to take over failing thrifts. In effect, the goodwill approach provided that the acquiring institution could purchase the "going concern" value of the failing thrift, and that the cost of acquiring that intangible asset would be reflected as an asset for purposes of computing regulatory capital. The recognition of goodwill was essential to FHLBB and FSLIC since it provided a market for the assets of the failing thrifts at a price exceeding the liquidation value of those assets. Thus, the sale of the going concern value of the failing thrifts was a key element of reducing FSLIC's cost with respect to a failing thrift. By adopting regulatory policies encouraging the use of purchase method accounting and supervisory goodwill for supervisory mergers, FHLBB and FSLIC substantially reduced the costs of financial assistance in such mergers.

B. THE ACQUISITION BY SECURITY SAVINGS OF AN INSOLVENT THRIFT IS ILLUSTRATIVE OF FHLBB POLICY OF INDUCING MERGERS AT A REDUCED COST THROUGH THE USE OF SUPERVISORY GOODWILL

Security Savings is an example of one of the healthy institutions which was willing to negotiate an agreement

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3/ Capital Assistance Acts and Deposit Ins. Flexibility Act, 1982: Before the Subcomm. on Housing and Dev. of the House Comm. on Banking, Finance and Urban Affairs, 97th Cong., 2d Sess. 70 (1982) (testimony of Richard T. Pratt, then Chairman FHLBB, at 84).

with FHLBB to acquire a failing thrift.

In December, 1982, FHLBB solicited acquisition proposals from private investors for North Mississippi Savings and Loan Association ("Old North"), which was an insolvent state chartered stock association. Security Savings, among others, submitted a proposal for an FSLIC-assisted acquisition of Old North. None of these proposals were ultimately accepted and in April, 1983, FSLIC was appointed as receiver for New North Mississippi Savings and Loan Association ("New North").

In December, 1983, a second attempt was made by FHLBB to locate a purchaser of New North. Security Savings was contacted by FHLBB and invited to again submit a proposal. FHLBB sent Security Savings a bid package which included instructions and components intrinsic to all bid proposals. Throughout the documentation of this transaction, FSLIC and FHLBB assured Security Savings, either explicitly or implicitly, that supervisory goodwill would be counted as regulatory net worth and this was a fundamental element in the transaction. The negotiations between Security Savings and FHLBB were conducted over a several month period and focused upon the critical terms of the acquisition, including the cash assistance provided by the government and the length of the amortization period for the goodwill.

The agreement that was finally negotiated between FHLBB and Security Savings was embodied in a resolution of FHLBB and in various ancillary documents. According to the FHLBB analysis prepared by FHLBB's staff at the time, *Security Savings's acquisition of New North saved FSLIC approximately $15 to $16 million dollars over the cost of liquidation*. This savings was the direct result of the willingness of Security Savings to assume liabilities in excess of the value of the identifiable

assets of New North. That willingness was dependent upon the essential premise of the transaction that Security Savings would account for the excess acquisition cost, in excess of identifiable assets -- the goodwill -- as an asset.

In granting Security Savings a permanent injunction, the district court found that both the documented evidence and testimony of the parties "demonstrates quite clearly that the inclusion of goodwill was the basic premise of the transaction," 761 F. Supp. at 1283, and that Security Savings was "contractually entitled to treat supervisory goodwill generated by the New North transaction as an asset." Id. at 1281.

Indeed, it is clear that the transaction was only possible based upon the inclusion of goodwill as an asset. As Security Savings' President, Mr. Bailey, testified, "Security would have been insolvent on the day of the transaction without the goodwill being established and being recognized from the auditors and the regulators as an asset. It would have been insolvent on that day." Id. at 1283. The State Commissioner of Savings of the State of Mississippi testified that he could not have approved the transaction had he known that the OTS would later take the position that Security Savings could not count the goodwill, since that would have placed Security Savings in an impaired condition which would have precipitated actions to place Security Savings into receivership. Id. Thus, the district court concluded "that all the parties considered the treatment of goodwill as an express term of the transaction which would endure regardless of any future interpretations or modifications of GAAP in the area." Id., *citing*, *Sterling Sav. Ass'n v. Ryan*, 751 F. Supp. 871 (E.D. Wash. 1990).

The conclusion of the district court in Security Savings's case is consistent with the findings of most of the district courts which have considered these issues. In

general, the majority of the district courts have determined that the assurances provided by FHLBB and FSLIC in these assisted transactions constituted binding contractual agreements which entitled the institutions to utilize a specific accounting method with respect to its capital computation. See e.g., Winstar Corp. v. United States, 21 Cl. Ct. 112, 115 (1990) (The evidence "leads this court to the firm conclusion that the government expressly intended to contract for the particular treatment of goodwill at issue in this case, notwithstanding changes in GAAP or in the statutory scheme."); Sterling Sav. Ass'n v. Ryan, 751 F. Supp. 871, 875 (E.D. Wash.), *appeal docketed*, No. 91-35101 (9th Cir. Dec. 27, 1990) ("[T]he court finds both the existence of a contractual relationship and the lack of a specific and unequivocal intent on the part of Congress to effect a taking . . . ."); Far West Fed. Sav. Bank, S.B. v. Director, Office of Thrift Supervision, 738 F. Supp. 1564 (D. Or.), *appeal docketed*, No. 90-35752 (9th Cir. Sept. 19, 1990); Franklin Fed. Sav. Bank v. Director, Office of Thrift Supervision, No. 2-90-166, slip op. (E.D. Tenn. July 16, 1990) (Forbearance agreements are binding contracts), *rev'd on other grounds*, 927 F.2d 1332 (6th Cir. 1991); Guaranty Fin. Servs., Inc. v. Director, Office of Thrift Supervision, 742 F. Supp. 1159, 1162 (M.D. Ga. 1990) (Forbearance agreement is likely a contract), *rev'd on other grounds*, 928 F.2d 994 (11th Cir. 1991); Security Fed. Sav. Bank v. Director, Office of Thrift Supervision, 747 F. Supp. 656, 658 (N.D. Fla. 1990) ("The evidence in this case strongly indicates to me that Security Federal bargained for, and received, a promise from the government that its unamortized deferred loan losses would be treated as a component of its regulatory capital for a period of approximately 215 months. In exchange for this promise, the directors invested $3.6 million. . . . The plaintiffs are correct that the 1987 conversion agreement bears all of the indicia of a contractual agreement. . . ."); Hansen Sav.

Bank v. Office of Thrift Supervision, 758 F. Supp. 240, 246 (D. N.J. 1991) ("The plaintiffs were willing to assume the $40,000,000 deficit as supervisory goodwill in the merged institution . . . if the government agreed to forbear from enforcing its capital standard regulations for a period of time. . . . This permitted the government to use its limited funds to facilitate other supervisory mergers."); Carteret Sav. Bank, FA v. Office of Thrift Supervision, No. 91-661, slip op. at 25 (D.N.J. April 25, 1991) ("Review of these various provisions, as well as a reading of the entire documents together, shows that the parties intended the entire agreement to include the terms relating to purchase method accounting in the forbearance letter and the resolution"), *appeal docketed*, No. 91-5290 (3d Cir. Apr. 23, 1991).

II. THE QUESTION OF WHAT IMPACT, IF ANY, FIRREA HAS UPON THESE CONTRACTS NEEDS AN IMMEDIATE, FINAL ANSWER

In response to the continuing crisis in the thrift industry, the Bush administration enacted FIRREA, which, among other things, established a new insurance fund for thrifts and made major structural changes in the regulation of the thrift industry. Included in these changes was the creation of the Office of Thrift Supervision (the "OTS"), as a successor to FHLBB to regulate and supervise all federally insured savings associations. Security Savings, as well as the other institutions engaged in similar litigation, contend that in enacting FIRREA, Congress made clear that the legislation would not impair the rights and obligations created by agreements entered into with FHLBB and FSLIC under the previous statutory scheme. Notwithstanding this clear intent, the position taken by the OTS has been to require

absolute compliance with the heightened standard of FIRREA, without exception and without regard to the previously negotiated agreements.

The single issue upon which each of these cases turns is the proper construction of those provisions of FIRREA. More specifically, whether FIRREA preserves the otherwise binding contractual agreements entered into by FHLBB and FSLIC as inducements to the healthy institutions and investor groups to take over the failing and insolvent thrifts. Thus far, at least seven of the district courts which have ruled on the issue have agreed with the institutions that FIRREA does not impair these prior obligations of the agencies and the corollary rights of the institutions. Far West Fed. Bank, S.B. v. Director, Office of Thrift Supervision, 738 F. Supp. at 1570; Security Sav. & Loan Ass'n v. Director, Office of Thrift Supervision, 761 F. Supp. at 1277; Sterling Sav. Ass'n v. Ryan, 751 F. Supp. at 880; Carteret Sav. Bank, FA v. Office of Thrift Supervision, No. 91-661, slip op. at 38; Hansen Sav. Bank v. Office of Thrift Supervision, 758 F. Supp. at 246. Two Courts of Appeal however have come to precisely the opposite conclusion. Franklin Fed. Sav. Bank v. Director, Office of Thrift Supervision, 927 F.2d 1332 (6th Cir. 1991); Guaranty Fin. Serv., Inc. v. Ryan, 928 F.2d 994 (11th Cir. 1991).

For the most part, the success of these challenges will be determinative of whether these institutions remain viable and independent, or whether they succumb to seizure by the OTS and become yet another drain upon the insurance funds and the taxpayers. The cases will continue to march through the courts, with uncertain

results. What is absolutely certain, however, is that until the United States Supreme Court considers this important issue and renders its decision, the viability and independence of otherwise healthy and sound institutions remains in the balance.

CONCLUSION

For the foregoing reasons, Security Savings respectfully urges this Court to grant the Petition for a Writ of Certiorari to the Sixth Circuit.

Respectfully submitted,

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